IN THE

Supreme Court of the United States

October Term, 1962.

No. 339

HENRIETTA O. MURDOCH,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT AS OF NO. 14,223.

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To the Honorable, the Chief Justice and the Associate Justices of the Supreme Court of the United States:

The Petition of Henrietta O. Murdoch respectfully represents:

REPORTS OF COURTS BELOW.

The opinion of the Court of Appeals for the Third Circuit is not as yet officially reported. It is printed in this petition (p. 12).

The memorandum findings of fact and opinion of the Tax Court are not officially reported. It is printed in the petitioner's appendix in the Court of Appeals (pp. 2a-12a). It is unofficially reported as "John H. Murdoch, T. C. Memo. 1962-196, CCH 1962."

JURISDICTIONAL GROUNDS.

(i) On June 7, 1963, the United States Court of Appeals for the Third Circuit, on petition to review a decision of the Tax Court of the United States, entered a judgment affirming the decision of the Tax Court.

(ii) On July 8, 1963, the Court of Appeals entered an order denying a petition for rehearing of said case.

(iii) The jurisdiction of your Honorable Court is invoked under the Act of June 25, 1948, Chapter 646, 62 Stat. 928 (28 U. S. C. A. 1254).

QUESTIONS PRESENTED.

1. Is the classification for tax purposes the nature and basis of the action settled; or does it turn on the form of the action and the phrasing of the settlement instrument?

2. How can a stockholder get income from another stockholder?

3. Upon the transfer of stock for cash, can the consideration be split into principal and income—the latter deductible by the purchaser and ordinary income to the seller?

STATUTE INVOLVED.

The statute involved is the *Internal Revenue Code of 1954, Section 1221*, the pertinent text of which reads:

> "Capital Asset defined. For purposes of this subtitle, the term 'capital asset' means property held by the taxpayer (whether or not connected with his trade or business), but does not include ——
>
> "(1) Stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business."

STATEMENT OF THE CASE.

The Court of Appeals for the Third Circuit affirmed a decision of the Tax Court that out of $36,500 received by your petitioner from her brother-in-law in settlement of a suit for shares of stock of which he had defrauded her the sum of $16,500 was ordinary income to her; and that he could deduct the $16,500 plus attorney's fees of $3,582.30 from his income. The Commissioner of Internal Revenue to this date agrees.

The widow Murdoch (your petitioner) owned stock.

Her brother-in-law got it from her.

She entered suit against her brother-in-law alleging he obtained title by fraud. She asked for financial information—an accounting.

The case was settled for $36,500, which he paid.

The settlement was split: $20,000 for the property with which he deceived her (which was stock in a phony corporation), and $16,500 for a general release of her brother-in-law and the corporations.

Her title ceased (assuming the settlement was fair).

She reported the entire $36,500 as capital gain on her original investment.

He deducted the $16,500 plus $3,582.30 ($20,082.30) as an expense.

In the statutory notice of deficiency (90 day letter) the Commissioner of Internal Revenue took an inconsistent position; i.e., he taxed the $16,500 to the widow as ordinary income (tax due $4,912.51); and he denied the deduction of $16,500 plus $3,582.30 attorney's fees to the brother-in-law (tax due $9,709.99).

In his brief to the Tax Court, the Commissioner sided with the brother-in-law.

The Tax Court and the Court of Appeals agreed with the brother-in-law and the Commissioner, on the ground that the widow's lawsuit asked for income from the brother-in-law. They quoted the prayers of her complaint.

However, both Courts found as a fact that the gravamen of her complaint was solely the fraud which deprived her of her stock.

As a matter of fact, the quoted prayers of the widow's complaint do not ask for income from her brother-in-law.

They ask only for financial information.

The widow loses $4,912.51.

The United States loses $4,797.48.

The brother-in-law saves $9,709.99.

JURISDICTION OF COURT OF FIRST INSTANCE.

Within ninety days of the issuance of a notice of deficiency by the Commissioner under Section 6212 of the Internal Revenue Code of 1954, the widow petitioned the Tax Court for a redetermination under Section 6213 of said Code.

The decision of the Tax Court was reviewed by the United States Court of Appeals for the Third Circuit under Section 7482 of said Code.

ARGUMENT FOR PETITIONER.

The Court of Appeals correctly states the facts.

An analogy will show how it reaches an erroneous conclusion: It finds as a fact, that the horse is white. Therefore, because the horse is black it is hard to see in the dark!

The Tax Court did the same thing. In my brief in the Court of Appeals, I characterized the statement of the Tax Court as "confused."

The widow's claim was for one thing—*and one thing only.*—as stated by the Court of Appeals:

> ". . . she charged him with having fraudently induced her to exchange her 49% interest in the stock of the John P. Murdoch Company for 49% of the shares of the stock of 3630 Haverford Avenue Corporation; . . ."

which was formed with only *part of the assets* of the Murdoch Company.

The first case cited by the Court of Appeals is *Carter's Estate v. C. I. R.*, 298 F. 2d 192 (8 Cir. 1962), cert. denied 370 U. S. 910 (1962), which case cited and relied upon *Raytheon Production Corp. v. Comm.*, 144 F. 2d 110, and we now quote from page 113:

> "The allegations and evidence as to the amount of profits were necessary in order to establish the value of the good will and business since that is derived by a capitalization of profits." * * * "Since the suit was to recover damages for the destruction of the business and the good will, the recovery represents a return of capital. Nor does the fact that the suit ended in a compromise settlement change the nature of the recovery; **'the determining factor is the nature of the**

> **basic claim**, from which the compromised amount was realized.' "

We agree with, *and rely on*, these cases.

In the *prayer* of her complaint, the widow asked for financial information—for **an accounting.** She had a right to know—the value of what she had been defrauded.

The Tax Court wrote (11a):

> "The main thrust of her complaint was an accounting from John in respect to profits to which she, *somehow or other*, claimed to be entitled." (Italics supplied.)

That just **is not so.** The **only** thrust of her complaint was that her brother-in-law:

> "fraudulently induced her to exchange her 49% interest in the stock of the John P. Murdoch Company for 49% of the shares of the stock of the 3630 Haverford Avenue Corporation;"

and the astonishing thing, apparent to any note editor of a law review, is that after stating this fact *and quoting verbatim her prayer* for an accounting and financial information the Court of Appeals concludes that $16,500 of the $36,500

> "was in settlement of her demand upon Mr. Murdoch to account to her for **profits to which she claimed to be entitled.**"

She made no claim *for the profits.*

She did not claim to be entitled to *any profits from John P. Murdoch, Jr.*

She had *no legal basis for a claim to the profits.*

She had one claim, *and one claim only*, against John P. Murdoch, Jr., and that was for stock of the John P. Murdoch Company—**and so says the Tax Court and the Court of Appeals.**

The law of the land determines her rights. Her only right against her brother-in-law was a capital right. If the case had gone to trial and she had prevailed, he would have returned to her the stock of the John P. Murdoch Company.

I know of no rights a stockholder has as such against another stockholder.

Unless the law of corporations is to be re-written, a stockholder's rights against a corporation are for dividends, when declared out of profits. The tax returns (25a) show *no dividends were ever paid* by the John P. Murdoch Company.

The division of the settlement money of $36,500 into two funds was a tax dodge pure and simple. The inexplicable position of the Commissioner seems like some sort of death wish.

The splitting of the $36,500 into two amounts of $20,000 and $16,500 was a fraud upon a fraud. So far, by it John P. Murdoch, Jr., has obtained a deduction of $16,500 plus attorney's fees of $3,582.30. This is contrary to all the decided cases, including those cited by the Court of Appeals and the recent cases of *U. S. v. Gilmore*, 372 U. S. 39, 44 (1963):

> "* * * 'conservation of property' seems to refer to operations performed with respect to the property itself, such as safeguarding or upkeep, rather than to a taxpayer's retention of ownership in it."

and *U. S. v. Patrick*, 372 U. S. 53, 57 (1963):

> "It would be unsound to make deductibility turn on the nature of the measures taken to forestall a claim rather than the source of the claim itself."

Sequential thought shows that this case as decided by the Court of Appeals changes "well settled law" and opens a loop-hole in the tax law. By acquiescing in the decision of the Court of Appeals the Commissioner of Internal Revenue has stamped with approval a tax evasion scheme. This case, important as it is to the widow Murdoch, may not involve a large amount compared to the fraud case involving 60,000 shares of Pepsi-Cola at $140 a share mentioned in the financial section of the New York Times July 14, 1963.

We need look no further than the very cases cited by the Court of Appeals:

> "It is well settled law that the classification for tax purposes of amounts received in litigation is to be determined by the **nature** and **basis** of the action settled." *Carter's Estate v. C. I. R.*, 298 F. 2d 192, 194.

> "Petitioners rely entirely on the **form of the settlement instrument**—an instrument of assignment rather than a release." *Estate of J. T. Longino*, 32 T. C. 904.

What was once "well settled law" has now become unsettled. The "nature and basis"—**the gravamen**—is no longer the determining factor, but the "prayers for relief" and the "form of the settlement instrument" now classify for tax purposes in the Third Circuit—with the acquiescence of the Commissioner of Internal Revenue. Open wide the doors!

The fraud was set up with the guidance of Harry J. Alker, Jr. (see Record p. 24a), who must now be chortling!

A swindler has saved $9,709.99, the widow has been hit with $4,912.51 and the United States has lost the difference of $4,797.48.

It is an interesting coincidence that McBride, von Moschzisker & Bradley were representing the widow in the fraud action at the same time they were representing her brother-in-law's lawyer (cf. Tax Court's findings of fact, and *U. S. v. Alker*, 260 F. 2d 135, cert. denied 359 U. S. 906, rehearing denied 359 U. S. 950):

Wherefore your petitioner, Henrietta O. Murdoch, respectfully prays that a writ of certiorari be issued to the United States Court of Appeals for the Third Circuit so that the law again may be "well settled" and—as you phrased it in *U. S. v. Patrick, supra*, the "source of the claim" may again determine taxability and the amount thereof.

Respectfully submitted,

HENRIETTA O. MURDOCH,
Petitioner,
By: HENRY D. O'CONNOR,
Attorney for Petitioner.

OPINION OF THE COURT.

(Filed June 7, 1963.)

By FORMAN, Circuit Judge.

PETITION FOR REVIEW BY HENRIETTA O. MURDOCH, No. 14,223.

John P. Murdoch and his brother Eugene K. Murdoch, each owned 49% of the stock of John P. Murdoch Company, a business they inherited from their father. For some years prior to his death, in September of 1945, Eugene K. Murdoch was ill and John P. Murdoch managed the business. Eugene K. Murdoch continued to draw a salary until his death, at which time his widow, Henrietta C. Murdoch, inherited his interest. Shortly thereafter John P. Murdoch and Mrs. Murdoch agreed that the physical assets, viz.: the real estate and production equipment of the John P. Murdoch Company, at 3630 Haverford Avenue in Philadelphia, would be transferred to a new corporation in exchange for its stock, of which 49% would be issued to Mrs. Murdoch in place of her shares in the John P. Murdoch Company and 49% would be held by Mr. Murdoch. The new corporation was named the 3630 Haverford Avenue Corporation. On December 31, 1946 it leased the premises and equipment to the John P. Murdoch Company for $1,200 per year plus taxes and mortgage interest. This rental arrangement continued until April 1, 1955, when the rent was increased to $5,000 per year without the obligation of the lessor to pay taxes or interest. Meanwhile Mr. Murdoch had been paying Mrs. Murdoch twenty dollars per week which he reduced at this time to ten dollars.

In June 1955 Mrs. Murdoch instituted an equity action against her brother-in-law in which she charged him with having fraudulently induced her to exchange her 49% interest in the stock of the John P. Murdoch Company for 49% of the shares of the stock of 3630 Haverford Avenue Corporation; that the fair rental value of the property and machinery was $6,500 per year, and demanded:

"(a) . . . an accounting of all the profits made by him by virtue of his ownership of 50% of the stock of the John P. Murdoch Company since the 1st day of January, 1945.

"(b) 49% of the fair rental value of the real estate and machinery leased by the 3630 Haverford Avenue Corporation to the John P. Murdoch Company from December 31, 1946 until December 31, 1954.

"(c) A complete accounting of all transactions of the John P. Murdoch Company and the 3630 Haverford Avenue Corporation from the 1st of January, 1945 to date.

"(d) Such other and further relief as this court may deem appropriate in the premises."

The litigation was settled before trial on December 11, 1957, as a result of which Mrs. Murdoch executed two documents. One was designated a "Release" and provided, as consideration for the payment to her of $16,500 that she released John P. Murdoch from all claims including those encompassed in the equity action and as well released the John P. Murdoch Company and the 3630 Haverford Avenue Corporation from all claims. The other document was designated a "Bill of Sale" and provided that in consideration of the payment to her of $20,000 she assigned to Mr. Murdoch her stock in the 3630 Haverford Avenue Corpora-

tion. Two checks were made by Mr. Murdoch payable to her lawyers. One was for $16,500 and contained on its face the statement "Payment in release of all claims in suit of Murdoch v. Murdoch, C. P. I." The other was in the sum of $20,000 and was marked "Payment in full for 49% shares 3630 Haverford Ave. Corp. stock."

In her income tax return for the year 1957 Mrs. Murdoch reported the full amount of $36,500 received from Mr. Murdoch as proceeds of the sale of "John P. Murdoch Co." and the resulting gain as being long term capital gain. The Commissioner determined that $16,500 of the $36,500 payment was taxable as ordinary income.

The Tax Court sustained the position of the Commissioner.*

Mrs. Murdoch seeks a review of the determination of the Tax Court. She asserts that the entire payment of $36,500 to her was a "sale or exchange" of a capital asset within the meaning of §§ 1221 and 1222 of the Internal Revenue Code of 1954 and that no part of it was ordinary income to her.

The pith of her argument is that Mr. Murdoch fraudulently induced her to part with her stock in the Murdoch Company for an amount less than subsequent disclosure revealed the book value to be; that Mr. Murdoch, individually, owed her no duty to pay income on her interest in the Murdoch Company; that the only source to which she could look for income was the Murdoch Company by way of dividends and that she did not make the company a party to her suit. Under these circumstances she reasons that her suit was for the restoration of her stock in the Murdoch Company and that the aggregate sum of $36,500 which she recovered in the settlement represents value for that stock.

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* John P. Murdoch, T.C. Memo. 1962-196, 7 C.C.H. 1962, Stand. Fed. Tax Rep. ¶ 7615(M).

no part of which is susceptible of being characterized as ordinary income.

The Tax Court considered that the nature and basis of her law suit and its settlement were revealed in her complaint and the papers which documented the settlement. It held that, absent other evidence to import meaning to the writings different from their contents, it was left with no other course than to find that the taxable nature of the $16,500 payment consistent with her complaint was in settlement of her demand upon Mr. Murdoch to account to her for profits to which she claimed to be entitled.

It has been said that:

> "It is now well settled that the classification for tax purposes, of amounts received in settlement of litigation is to be determined by the nature and basis of the action settled. Amounts received in compromise of a claim must be considered as the same nature as the right compromised." (Footnotes omitted.) 3B Mertens, Law of Federal Income Taxation, 22.93, at 358-359 (1958).

Carter's Estate v. C. I. R., 298 F. 2d 192, 195 (8 Cir. 1962), cert. denied 370 U. S. 910 (1962); Fowler Hosiery Co., 36 T. C. 201, 223-4 (1961) aff'd 301 F. 2d 394 (7 Cir. 1962); Estate of J. T. Longino, 32 T. C. 904 (1959); Albert J. Goldsmith, 22 T. C. 1137, 1144-45 (1954); Peter K. Pappas, T. C. Memo. 1962-203, 7 C. C. H. 1962, Stand. Fed. Tax Rep. ¶7628(M). The taxpayer has the burden of proving what portion, if any, of a settlement is entitled to capital gains treatment. Carter's Estate v. C. I. R., supra at 194-5; Peter K. Pappas, supra.

A review of the record in the Tax Court satisfies us that Henrietta O. Murdoch did not sustain her burden of proof and that there is substantial evidence to sustain the judgment of the Tax Court that the $16,500 payment was tax-

able as ordinary income. Hence, the judgment of the Tax Court sought to be reviewed in case No. 14,223 will be affirmed.

PETITION FOR REVIEW BY COMMISSIONER OF INTERNAL REVENUE NO. 14,222.

In the joint return for the year 1957 by John P. Murdoch and his wife, Eleanor, the payment of $16,500, which is the subject of review in the foregoing case, No. 14,223, together with $3,582.30 for attorney's fees expended in connection with the suit of Henrietta O. Murdoch against Mr. Murdoch, was deducted as an ordinary and necessary business expense under §162(a), or in the alternative, under §212 of the Internal Revenue Code of 1954. In the Tax Court the Commissioner conceded that there should be "consistent treatment of the payment" in both cases.** The Tax Court accordingly, having found against the claim of deductibility by Mrs. Murdoch, held that Mr. Murdoch was entitled to the deduction of $16,500, based on the concession of the Commissioner, as well as the deduction of the attorney's fees, since the Commissioner had also expressed no objections to the same treatment of the fees as accorded the payment of $16,500.

The present petition for review by the Commissioner is of a "protective" nature to cover the contingency that would ensue if the Tax Court's judgment against the claim for deduction by Mrs. Murdoch were reversed. We intimate no opinion on the merits of the deductibility of the items claimed by Mr. Murdoch. The judgment of the Tax Court that he is entitled to deduct the payment of $16,500 and attorney's fees of $3,582.30, based on the concession made by the Commissioner, will be affirmed.

** The issues underlying the petitions for review in No. 14,223 and No. 14,222 were heard together both in the Tax Court and here.